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A Very Quiet Revolution: A Primer on Securities Crowdfunding and Title III of the JOBS Act

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A VERY QUIET REVOLUTION: A PRIMER ON SECURITIES CROWDFUNDING AND TITLE III OF THE JOBS ACT

*Thaya Brook Knight, Huiwen Leo, and Adrian A. Ohmer**

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I. INTRODUCTION

Since the early 2000s, “crowdfunding” has emerged as a means of obtaining funds for new and innovative projects.¹ At its most basic level, crowdfunding means using a method of mass communication, typically the Internet, to solicit funds from the community at large, with the project creator receiving small individual amounts of funding from a large number of donors or investors. Until the recent passing of the Jumpstart Our Business Startups Act (the JOBS Act), however, there was no legal way for businesses to tap this network to offer a financial interest (either as debt or equity) to the public without registering the offering with the Securities and Exchange Commission (SEC). Instead, crowdfunding platforms have focused on four types of funding: (1) donation-based, in which contributors receive nothing in exchange for their funds; (2) rewards-based, in which contributors receive a token item, such as a t-shirt or a credit in a film made with the donations; (3) pre-sale, in which contributors have the option to purchase a desirable product in advance of its availability to the wider market; and (4) peer-to-peer lending, which permits individuals to

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1. See, e.g., *About Us*, ARTISTSHARE, <http://artistshare.com/v4/home/about> (last visited Oct. 27, 2012) (founded October 2003); *About Us*, INDIEGOGO, <http://www.indiegogo.com/about/our-story> (last visited Oct. 27, 2012) (founded in 2008); Yancey Strickler, *Happy Birthday Kickstarter!*, KICKSTARTER (Apr. 28, 2011), <http://www.kickstarter.com/blog/happy-birthday-kickstarter> (founded April 2009).

lend money directly to borrowers.² The result has been that crowdfunding has previously focused on projects such as artistic works, community service, and product development for items with a sufficiently high coolness factor to draw donors despite the lack of financial gain.³ While many entities – both for-profit and non-profit – are already active crowdfunding users, not every business model lends itself to the type of crowdfunding that has thus far been available in the United States.

With the President's signing of the JOBS Act in April 2012, however, there is a new exemption under the securities laws that will permit the sale of securities via crowdfunding, thus opening the doors to those businesses that have been unable to utilize existing crowdfunding methods.⁴ There is

2. There is some uncertainty regarding the legality of some types of peer-to-peer lending. One type may be seen as purely altruistic. In this model, lenders provide funding for projects and receive repayment of their investment, but without interest. Kiva, which provides micro-finance for small businesses in the developing world, is the best-known example of this model. *See*, KIVA, <http://www.kiva.org/start> (last visited Oct. 27, 2012). This type of loan does not meet the definition of a security because the lender has no expectation of profit. *See, infra* note 25. Another model provides loans for a number of purposes and provides the lender with repayment plus interest. This model has been the subject of debate because it is difficult to distinguish these types of loans from bonds, which are clearly securities. In 2008, the peer-to-peer lending site Prosper Marketplace, Inc. settled with the SEC following the SEC's finding that Prosper Marketplace's loans were securities and that the company had therefore violated the securities laws in failing to register them. Prosper Marketplace, Inc., Securities Act Release No. 8984 (Nov. 24, 2008). A similar site, Lending Club, registered with the SEC around the same time that the SEC was investigating Prosper Marketplace's activities. Lending Club Corp., Registration Statement (Form S-1) (June 20, 2008).

3. As an example of what product has such "coolness" factor, the Pebble Watch, a watch with an e-ink screen that runs applications from smartphones, made headlines in early 2012 by raising \$2.7 million in three days. Anthony Wing Kosner, *Pebble Watch for iPhone and Android, The Most Successful Kickstarter Project Ever*, FORBES (Apr. 15, 2012), <http://www.forbes.com/sites/anthonykosner/2012/04/15/pebble-watch-for-iphone-and-android-the-most-successful-kickstarter-project-ever/>. Because these transactions are not sales, exactly, but an exchange of funding for a product, there may be a price differential between the amount a funder provides and the amount the item ultimately costs once produced. A funder may therefore obtain an item for less than its purchase price by making an early donation. The funder, however, also assumes the risk that the product may not ultimately be made despite the developer completing a successful raise. (Pebble Watch has reported challenges in meeting its production schedule in the wake of its wildly successful fund-raising campaign. Pebble Technology, *Orange Wins! + Manufacturing Prototype Photos*, KICKSTARTER (Jul. 24, 2012), <http://www.kickstarter.com/projects/597507018/pebble-e-paper-watch-for-iphone-and-android/posts/273665> (noting that watches will not be delivered in September as promised)). Given the price differential and the associated risk, there may also be an argument that this type of transaction is indeed a securities offering and must therefore be regulated as such. *See, e.g.*, WASH. REV. CODE § 21.20.005, § 17(a) (2011) (defining a security as, *inter alia*, an "investment of money or other consideration in the risk capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture").

4. Although the President has signed the Act into law, the Act requires the SEC to promulgate several rules before any offers may be made. The deadline for issuing these rules is December 31, 2012, according to the Act. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(c), 126 Stat. 306, 320 (2012). As of publication, there have been no rules

a temptation to view this type of crowdfunding as a sort of “Kickstarter plus.” In fact, the methods commonly used on sites like Kickstarter are likely to cause problems if borrowed wholesale for securities crowdfunding. To date, one of the hallmarks of crowdfunding has been its passion. Sites like Kickstarter encourage this spirit, advising those pitching projects, “[i]f you have computer access and a ready supply of enthusiasm, you’ve got all you need.”⁵ Unfortunately, selling securities requires more than enthusiasm. While the start-up world seeks disruptive solutions – often the more disruptive the better – Congress built the JOBS Act into the same old regulatory regime that was born nearly 80 years ago in a very different (and certainly pre-Internet) world. Title III of the JOBS Act is no entrepreneurial barbarian storming the gates of finance to supplant the old order with the new. Instead, the entrepreneur has been invited in and informed that togas are required; a loaner will be provided if necessary. Disruption will be narrowly confined. Ultimately, using crowdfunding to sell securities will require two disparate cultures to merge: the shoot-from-the-hip culture of the start-up world; and the detail and disclosure oriented world of securities law. This world is less “Kickstarter plus” and more “Merrill minus.”

This essay introduces the complex regulatory regime that governs the public sale of all securities, no matter how small the offeror. It is intended as a rudimentary roadmap for the start-up or its counsel and will, hopefully, help to illuminate the traps for the unwary while providing an overview of the regulatory universe in which securities crowdfunding will operate.

To understand how the crowdfunding exemption works, it is necessary to understand the ways in which the JOBS Act has changed this regulatory regime and the ways in which the regime has remained the same. Broadly speaking, Title III of the JOBS Act changed the Securities Act of 1933 (“Securities Act” or “1933 Act”) and the Securities Exchange Act of 1934 (“Securities Exchange Act” or “1934 Act”) in the following ways, each of which will be explored in the following sections:

1. It changed the registration provisions of the Securities Act governing publicly offered securities for a narrowly-defined class of offerings;
2. It changed the registration provisions of the Securities Exchange Act governing the triggers that require registration of a class of securities under the Exchange Act, but only for limited purposes; and
3. It changed broker-dealer registration requirements to create a new entity, the funding portal, which is permitted to undertake some functions that

issued nor has the SEC announced proposed rulemaking under § 553(b) of the Administrative Procedures Act. It therefore is unlikely that the SEC will issue rules by the December 31 deadline. The Act also requires portals to be registered with a self-regulatory organization, which will likely be the Financial Industry Regulatory Authority (FINRA). Jumpstart Our Business Startups Act, Pub. L. No. 112-106, sec. 302(b), § 4A(a)(2), 126 Stat. 306, 316 (2012). FINRA has not yet published information on what portals must do to meet this requirement.

5. *Kickstarter School*, KICKSTARTER, http://www.kickstarter.com/help/school/making_your_video (last visited Oct. 27, 2012).

would previously require registration as a broker, but which still has to be registered with the SEC.

While there is no doubt that these are disruptive changes in the securities world, the entrepreneur and its counsel must also understand what has not changed: *everything else*. What this means is that, while the JOBS Act has created a new space in the securities laws for crowdfunding, that space is tightly circumscribed and companies seeking crowdfunding stray outside its boundaries at their peril. This essay will examine in turn the implications for issuers, funding portals, and investors of importing a new type of crowdfunding into the existing, and sometimes Byzantine, regulatory environment.

II. FIRST CHANGE: SECTION 5 OF THE SECURITIES ACT

Since the passing of the Securities Act in 1933, a fundamental rule of securities law has been this: if you offer securities to the general public, you must register the offering with the SEC.⁶ There have, however, always been limited exemptions. For example, offerings that are offered and sold exclusively within the issuer's home state must comply with state securities laws (so-called "Blue Sky" laws) but need not register with the SEC.⁷ There is also an exemption for certain small offerings of, until recently, up to \$5 million.⁸ This exemption, however, has been used rarely in the past because, while registration with the SEC is not required, the exemption imposes registration requirements at the state level that made the exemption cost prohibitive given the limitations on the size of the offering.

Because these exemptions have been so limited, most companies seeking to access the capital markets have had to register their offerings with the SEC. This requirement has excluded many companies from these markets, given the expense of conducting the necessary due diligence, preparing required filings for the SEC, and attracting an underwriter, who typically takes a portion of the funds raised as its fee. This left small companies (anyone seeking less than roughly an eight-figure raise) with a handful of options: self-funding; small business loans from a bank; investments from friends and family;⁹ investments from so-called "angel" inves-

6. Securities Act of 1933 § 5, 15 U.S.C. § 77e (2006).

7. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (2006).

8. Regulation A, 17 C.F.R. §§ 230.251–230.263 (2012). Title IV of the JOBS Act seeks to alleviate some of the burden imposed by Regulation A, to make the exemption more attractive to issuers. Most importantly, it raises the cap on offering size to \$50 million, and also reduces the burden of other requirements. It may be expected, if the changes do indeed make the exemption more useful, that some companies who initially seek crowdfunding may choose either to seek funding under the new Regulation A (nicknamed "Reg A+") instead or to conduct a follow on raise under Regulation A when additional funding is needed.

9. Issuers should be very careful when seeking investment from friends and family. This process may appear to be informal and thus the issuer may not realize it is engaging in an offering of securities. Despite appearances, such investments do constitute an offering

tors (wealthy individuals who invest sizeable amounts, typically in start-ups, in exchange for debt or equity)¹⁰; and venture capital funding. Each of these has its own limitations: self-funding or funding from friends and family may be out of reach for all but the wealthiest; banks have imposed increasingly stringent requirements since the economic downturn and typically require loans to be collateralized;¹¹ angels and venture capital firms, which provide funding to only a limited number of businesses,¹² are often unwilling to consider an investment of less than a quarter million in the case of angels or as much as a million in the case of venture capital firms.¹³

The company that needs just a few hundred thousand dollars has faced a considerable challenge. Moreover, the ability of a person of average means to participate as an investor in the start-up world has been almost nonexistent. The new crowdfunding exemption permits a person of average means to provide seed capital for a stranger's nascent enterprise halfway across the country. This is indeed a disruptive proposition in the securities world.

The mechanics of the new exemption work like this. A company may offer up to \$1 million in securities (debt, equity, or a combination of both)

and must therefore satisfy the requirements of one of the exemptions in the Securities Act in order to be legal without registration with the SEC. Such irregularities often are not discovered until a company prepares for its initial public offering (IPO). At that point, there is often substantial work required to clean up the company's stock holdings, including occasionally requiring rescission offers to undo previous offers.

10. Regulation D, 17 C.F.R. §§ 230.501–230.508 (2012). The JOBS Act also includes additions to Regulation D, lifting the restriction on general solicitation provided all investors are accredited. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201, 126 Stat. 306, 313 (2012).

11. See, e.g., THE CONG. OVERSIGHT PANEL, MAY OVERSIGHT REPORT, THE SMALL BUSINESS CREDIT CRUNCH AND THE IMPACT OF TARP, at 47-59 (May 13, 2010) (discussing the effect of the recession on small business lending). Plummeting home values have also reduced the availability of bank loans for small business owners who have traditionally used their homes as collateral for business loans. *Id.*

12. Angels provided funding to fewer than 70,000 businesses in 2011, with total investments reaching \$22.5 billion. JEFFREY STOHL, UNIV. OF N.H. CTR. FOR VENTURE RESEARCH, FULL YEAR 2011 ANGEL MARKET ANALYSIS REPORT (Apr. 13, 2012), <http://wsbe.unh.edu/cvr-analysis-reports>. In the first half of 2012, venture capital firms completed 1,707 deals, investing \$13 billion. PRICEWATERHOUSECOOPERS & NAT'L VENTURE CAPITAL ASSOCIATION, MONEYTREE REPORT Q2 2012, 2, http://www.pwcmoneytree.com/MTPublic/ns/moneytree/filesource/exhibits/Q2%202012%20MoneyTree%20Report_FINAL.pdf. As a point of comparison, there were nearly 30 million companies in the United States as of 2008, and close to 6 million of those were large enough to have employees. U.S. Census Bureau, *Statistics about Business Size (including Small Business) from the U.S. Census Bureau*, tbl.2a, <http://www.census.gov/econ/smallbus.html>.

13. The average raise from a round of angel investment is just over \$300,000. JEFFREY STOHL, UNIV. OF N.H. CTR. FOR VENTURE RESEARCH, FULL YEAR 2011 ANGEL MARKET ANALYSIS REPORT (Apr. 13, 2012), <http://wsbe.unh.edu/cvr-analysis-reports>. Average investment by a venture capital firm is around \$3 million for a seed stage investment and around \$5 million for an early stage investment. PRICEWATERHOUSECOOPERS & NAT'L VENTURE CAPITAL ASSOCIATION, MONEYTREE REPORT (2012), http://www.pwcmoneytree.com/MTPublic/ns/moneytree/filesource/exhibits/Q2%202012%20MoneyTree%20Report_FINAL.pdf.

to the general public.¹⁴ Thus far, there is no restriction on who may invest, although would-be investors do have to pass a financial literacy test; the exact nature of that test has not been determined at the time of this writing. While it is likely that any investor who passes the test will be permitted to invest, the Act places restrictions on how much any issuer can sell to any one investor based on the investor's income or assets. An investor with annual income or net worth less than \$100,000 may invest only the greater of \$2,000 or 5 percent of annual income or net worth in crowdfunding securities in any given year. An investor with income or net worth greater than \$100,000 may invest 10 percent of annual income or net worth, up to a limit of \$100,000.¹⁵ Any securities purchased as part of an offering may not be transferred for one year unless they are transferred to the issuer, an accredited investor,¹⁶ as part of a registered offering, or to the purchaser's relative in connection with an event such as death or divorce.

Although the issuer is not required to register the offering, it must make certain disclosures, which must be filed with the SEC and made available to potential investors.¹⁷ These disclosures include basics such as the name and address of the issuer, the identities of its officers and directors, and description of its business plan, as well as more detailed information such as the company's financial condition, financial statements¹⁸ and capital structure. The issuer must also disclose how much it wants to raise, what it intends to do with the money raised, and what the price of the

14. The Act discusses securities sold to "any investors." Elsewhere in the Securities Act, "investors" means the general public and not, for example, "accredited investors." It seems likely that the term "investors" will have the same meaning here.

15. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, sec. 302(a), § 4(a)(6)(B), 126 Stat. 306, 315 (2012). This is an area that will require additional guidance from the SEC to determine whether, for example, a person with a net worth of \$100,000 but no income would be capped at \$10,000 investment or at 5 percent of net worth, or \$5,000.

16. An "accredited investor" is, generally, an investor who, because of wealth or financial sophistication, requires less regulatory protection than the general public. Securities Act of 1933 § 2(a)(15), 15 U.S.C. § 77 (2006). *See also* 17 C.F.R. § 230.215 (2012).

17. We use the term "filed" because that is the term that appears in the JOBS Act. This term is somewhat imprecise, however, because "filed" in the securities world typically implies registration. A better term might have been "provided" or "furnished" to the SEC.

18. The type of financial statement required is scaled to the size of the offering. For an issuer seeking \$100,000 or less, the issuer must provide only the issuer's tax returns and financial statements. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, sec. 302(b), § 4A(b)(1)(D)(i) (2012). For a raise of \$100,000 to \$500,000, the issuer must provide financial statements that have been reviewed by an independent public accountant. *Id.*, at § 4A(b)(1)(D)(ii). Issuers seeking \$500,000 to \$1 million, however, must provide audited financial statements. *Id.*, § 4A(b)(1)(D)(iii). The SEC is permitted under the statute to change the minimum raise under this last category if it sees fit. *Id.* Additionally, it should be noted that while the Act requires that, for the last category, the issuer's financial statements must be "audited" by an independent public accountant, the SEC has said that this will likely mean something less than a full audit for a public company. The Act permits the SEC to use its discretion in determining what standards the accountant must use in performing this review. *Id.*, at § 4A(b)(1)(D)(ii).

securities will be (and how the issuer will determine the price). Taking a page from the world of donation crowdfunding, where some platforms require a project to meet its full funding target before it receives any of the money pledged,¹⁹ the Act also requires each issuer to disclose a deadline for reaching its target and precludes the issuer from receiving any money if it does not reach this target.²⁰

These disclosures, while not insubstantial, nonetheless are significantly less burdensome than those required for a traditional IPO.²¹ Moreover, the issuer, anticipating the receipt of much needed funding, will be motivated to collect and produce the required documents.

More burdensome, especially for bare-bones start-ups, may be the Act's ongoing reporting requirements. A company that has issued securities through crowdfunding is required to make annual disclosures to the SEC and to its investors, reporting on the company's operations and producing its financial statements. While the substance of this requirement may be fairly minimal (depending on what the SEC's final rules look like), issuers will need to take steps to ensure that the annual reporting is done even when the company's attention may have long shifted away from crowdfunding and on to newer endeavors, a challenge in the dynamic environment in which most start-ups operate.

Another provision that will require a certain paradigm shift for many start-ups is the restriction on advertising. The JOBS Act requires that crowdfunding issuers "not advertise the terms of [their] offering[s], except for notices which direct investors to the funding portal or broker[.]"²² This restriction may be the greatest trap for the unwary in this space. Large issuers, or companies anticipating a full scale IPO will have suffi-

19. See, e.g., FAQ: *Kickstarter Basics: Kickstarter 101*, KICKSTARTER, <http://www.kickstarter.com/help/faq/kickstarter%20basics> (last visited Oct. 20, 2012); see also, *How Pricing Works on Indiegogo*, INDIEGOGO, <http://www.indiegogo.com/learn/pricing> (last visited Oct. 20, 2012).

20. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, sec. 302(b), §§ 4A(a)(7), 4A(b)(1)(F), 126 Stat. 306, 316-17 (2012).

21. See CONSTANCE E. BAGLEY & CRAIG E. DAUCHY, *THE ENTREPRENEUR'S GUIDE TO BUSINESS LAW* 651 (Jack W. Calhoun et al. eds., 2003) ("[t]he going-public process is expensive, often costing more than \$1 million in filing fees to the Securities and Exchange Commission, state securities filing fees, stock exchange or over-the-counter registration fees, legal fees, accounting fees, printing costs, and increased premiums for director and officer liability insurance.").

22. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, sec. 302(b), § 4A(b)(2), 126 Stat. 306, 318 (2012). Even on the funding portal or broker website, issuers must take care in what means they use to promote their offering. In the donation crowdfunding world, project creators typically use videos to present their project, creating what is best described as an advertisement. Use of such a video, especially one that presents the issuer and its business operations only in a positive light, may create liability for the issuer (and platform). Anything included in the video will constitute a statement made "in connection with the purchase or sale of any security" and therefore will render the issuer and possibly the platform liable for any material misstatements, or omissions that may make a statement otherwise misleading. 17 C.F.R. § 240.10b-5 (2012).

cient experience and hired expertise to understand what can and cannot be said while an offering is in the works. For a new company, however, self-promotion is as natural and necessary as breathing. Would-be issuers may be tempted to employ the same tactics to promote their securities offerings that they have found successful in promoting their business and its products. Even issuers who have a basic understanding of the restrictions on advertising, and who therefore avoid any description of their offering beyond the basic information permitted by the Act, may nonetheless fail to grasp how broadly the SEC defines the term “offer.” Under the Securities Act, an offer to sell includes any activity reasonably calculated to solicit or generate a buying interest, even if it includes no mention of the actual securities.²³ An issuer may post promotional material about its business, completely unaware that this material may constitute impermissible market conditioning under the SEC’s rules.²⁴ Just as an orange-grower may fail to recognize his plots of land as securities,²⁵ a small entrepreneur may fail to recognize her well-intentioned advertisement as a violation of the securities laws.²⁶

While many of the other changes implemented by the Act are disruptive in their own way, the change to Section 5 of the Securities Act is the granddaddy of them all. It offers relief from the burden of a full scale IPO, but it may lull issuers into a false sense of freedom. It is crucial that issuers understand that offerings under the crowdfunding exemption do not occur outside of the securities laws but merely are subject to an exemption from certain (albeit major) provisions.

23. Publication of Information Prior to or After the Effective Date of a Registration Statement, Securities Act Release No. 33-3844, 1957 WL 3605 (Oct. 8, 1957) (Example 1). This typically applies to the so-called “quiet” period before the registration of a company becomes effective. Although crowdfunding is exempt from registration, the SEC has stated that offers are not permitted before the final rules under Title III of the JOBS Act are in effect. See, e.g., *Information Regarding the Use of the Crowdfunding Exemption in the JOBS Act*, S.E.C., www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm. It is reasonable to assume that the term “offer” in the context of crowdfunding will have the same meaning that it has in the broader context for all types of securities offerings.

24. Securities Act Release No. 33-3844, 1957 WL 3605 (Oct. 8, 1957).

25. In *SEC v. Howey Co.*, a real estate developer offered to purchasers of certain lots containing citrus trees, management contracts under which a company affiliated with the developer would pick and market the fruit with the lot owners reaping the profits. *SEC v. Howey Co.*, 328 U.S. 293, 295-97 (1946). The Supreme Court found that these contracts constituted securities and articulated the following test, which remains to this day the test for determining what constitutes a security under federal law: “an investment contract, for purposes of the Securities Act, means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.” *Id.* at 298-299.

26. The Act also places restrictions on the issuer’s ability to compensate a broker or funding portal for promoting its offering. The nature of these restrictions is not yet known since the Act instructs the SEC to promulgate rules governing the compensation that may be provided and what disclosures must be made if such compensation is made or promised.

III. SECOND CHANGE: REGISTRATION UNDER THE SECURITIES EXCHANGE ACT OF 1934

The JOBS Act provides a second registration exemption for crowdfunding: exemption from the requirement under the Securities Exchange Act that any issuer with 2,000 accredited or 500 non-accredited shareholders register, even if the issuer has no individual offering that required registration under the Securities Act.²⁷ For crowdfunding to work as intended, this is a necessary exemption. Without it, an issuer would quickly reach the shareholder threshold and trigger the registration requirements. To see this in action, let's do the numbers. With per investor investment capped at \$100,000 for the wealthier investors, a raise of \$500,000 will have at least five investors. If the investors all have incomes or assets under \$100,000 (not an unlikely scenario since median household income in the U.S. in 2010 was under \$50,000),²⁸ even a small \$100,000 raise will have at least 50 investors. Obviously not all investors will invest the full \$2,000 or \$100,000 they are allowed to invest. It is not ridiculous to think that a \$100,000 raise may have hundreds if not thousands of investors and would therefore easily reach the 500 non-accredited shareholder trigger.

Although this exemption solves one problem, it highlights another. At the lower end of the spectrum, with a \$100,000 raise, we are already looking at a potential shareholder class numbering into the thousands. At the upper end of the scale, a \$1 million raise could have 10,000 or more investors. The Act does not prescribe a method for the issuer to use to keep track of all of these investors. It is likely that the private sector will develop a tool or service for issuers to use to keep an investor roster and to disseminate disclosures and information as needed. It is also possible that the platforms themselves will begin to offer a service that would meet issuers' needs. In the meantime, an issuer or its counsel would be well advised to devise a system for tracking and communicating with investors *before* the first security is sold to prevent scrambling later on.²⁹

Even with this exemption, however, a crowdfunded company may not escape registration altogether. First, the JOBS Act does not make the exemption available as a matter of course for all crowdfunding issuers. In-

27. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 303(a), 126 Stat. 306, 321 (2012). Prior to the JOBS Act, Section 12(g) of the Exchange Act required registration once an issuer had total assets exceeding \$1,000,000 and a class of security held by 500 or more persons of record. Section 501 of the JOBS Act increases the thresholds to total assets exceeding \$10,000,000 and a class of equity security held of record by either 2,000 persons or 500 persons who are not accredited investors. 15 U.S.C. § 781(g)(1)(A) (2006); Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012).

28. *Income, Poverty, and Health Insurance Coverage in the United States: 2010*, U.S. CENSUS BUREAU, 5 (Sept. 2011), <http://www.census.gov/prod/2011pubs/p60-239.pdf>.

29. Future investors, such as venture capital funds, may be wary of investing in a company with such a large shareholder class. An issuer may mitigate this concern by having a tidy means of handling the shareholders, thus reassuring the venture capital fund that the crowdfunding raise will not create headaches down the line.

stead, it states that “the Commission shall, by rule, exempt, conditionally or unconditionally, securities acquired pursuant to an offering made under” the new crowdfunding exemption from the requirement that issuers register when they hit certain thresholds.³⁰ Whether the SEC will choose to make the exemption available “unconditionally” and, if not, what the conditions will be is still unknown. Second, an issuer may still trigger the registration requirement if the secondary market for its securities is sufficiently large. It is not yet clear how large the secondary market for securities originally sold through crowdfunding may be, although it is likely that the demand will vary from issuer-to-issuer (presumably if the next Google gets its initial funding from the crowd, those shares may come to be very valuable indeed). But if these securities are subsequently sold in the secondary market, they will count toward the cap (unless the SEC provides otherwise) and start the tally running that will require the issuer to register if the number of shareholders hits the threshold.³¹

With these new exemptions, a startup now has the potential to have hundreds, or even thousands, of small crowdfunding investors prior to an initial public offering or even a venture capital round. While managing such a large shareholder class will present challenges, including the disclosure requirements discussed above, these challenges may be off-set by advantages such as the issuer’s ability to retain greater control of the company than would typically be available through a venture capital or even angel round.³² Thankfully, there is also a robust market developing to deliver services to companies seeking crowdfunding, which will assist them in addressing these challenges and realizing the advantages.³³

30. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 303(a), 126 Stat. 306, 321 (2012).

31. Neither the JOBS Act nor the Exchange Act currently includes any exemption from registration for an issuer with a class of securities held by 2,000 or more investors, and therefore it may be assumed that a company reaching this cap through a crowdfunding offering will be required to register. 15 U.S.C. § 78l(g)(1)(A) (2006). The SEC may decide to exclude shares issued through a crowdfunding offering using an approach to identification similar to that used in Rule 144A offerings. That is, the shares issued through the crowdfunding offering could be excluded from the cap, with a dedicated CUSIP used for that offering to track those shares separately from any other stock issued by the company that would count toward the trigger. There is, however, no such exemption on the books.

32. Although an issuer may give up a certain amount of equity in a crowdfunding offering, the number of shares – and therefore amount of control – any one investor may own is strictly limited by the JOBS Act. It is therefore unlikely that any one shareholder would have sufficient power to influence the issuer’s business in the way that venture capital funds often require.

33. See generally CROWDCHECK (<http://crowdcheck.com/>); EQUITYNET (<https://www.equitynet.com/>); FUNDING ROADMAP (<http://fundingroadmap.com/>). One way to manage the crowd would be to have the crowd invest in a special purpose vehicle, which would in turn invest in the crowdfunding offering. This way, the company would only deal with one investor. This would only be feasible if the special purpose vehicle was able to fall within an exemption to the Investment Company Act of 1940. All companies that invest in other companies (such as these special purpose vehicles) are deemed to be “investment companies” under the Investment Company Act. 15 U.S.C. § 80a-3(a)(1) (2006). All “investment compa-

IV. THIRD CHANGE: BROKER-DEALER REGISTRATION

Another fundamental principle of securities law is that if you are “engaged in the business of effecting transactions in securities for the account of others,”³⁴ or “engaged in the business of buying and selling securities” for your own account,³⁵ you are a broker or dealer and therefore must register with the SEC.³⁶ There have been some exemptions – for broker-dealers whose business is strictly intrastate³⁷ or for banks that engage in certain transactions,³⁸ for example – but these have been fairly limited. Before the JOBS Act was passed, there was speculation as to whether platforms featuring crowdfunding issuers would be broker-dealers under the Exchange Act,³⁹ especially as they do not seem to meet any of the existing exemptions.⁴⁰ This is not a question that need worry potential

nies” are required to register under the Investment Company Act unless they fall within an exemption from the registration provisions. 15 U.S.C. § 80a-8 (2006). Rule 3(c)(1) of the Investment Company Act of 1940 provides an exemption if the hedge fund has fewer than 100 investors, who are typically accredited investors and qualified purchasers. 15 U.S.C. § 80a-3(c)(1) (2006). Rule 3(c)(7) provides an exemption if the hedge fund has only qualified purchasers as investors, and the fund has no more than 499 investors. 15 U.S.C. § 80a-3(c)(7) (2006). The qualified purchaser is typically an individual with a net worth of \$5 million or an institution with a net worth of \$25 million. 15 U.S.C. § 80a-2(a)(52)(A) (2006). However, since these exemptions are limited to either accredited investors or qualified purchasers, the high net worth of the investors would exclude most of the everyday investors that crowdfunding is targeted at.

34. Securities Exchange Act of 1934 § 3(a)(4)(A), 15 U.S.C. § 78c(a)(4) (2006).

35. Securities Exchange Act of 1934 § 3(a)(5)(A), 15 U.S.C. § 78c(a)(5)(A) (2006). This definition does not include “a person that buys or sells securities for such person’s own account. . . but not as a part of a regular business.” Securities Exchange Act of 1934 § 3(a)(5)(B), 15 U.S.C. § 78c(a)(5)(B) (2006).

36. Securities Exchange Act of 1934 § 15(a), 15 U.S.C. § 78o(a) (2006).

37. *Id.*

38. *Id.*, §§ 3(a)(4)(B), 3(a)(5)(C).

39. See, e.g., C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 51-67 (2012).

40. There is, for example, an elusive “finder’s” exemption, which exempts a person who introduces a buyer and a seller of securities to one another. See Anka, Paul, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,797 (July 24, 1991). At first blush, this exemption seems uniquely suited to rescue funding portals from registration since their business model consists of matching companies seeking funding with investors looking to invest. The SEC staff does not often find this exemption to be applicable, however, even when the individual’s proposed activity would be strictly confined to connecting a buyer and seller who have already indicated an interest in a certain type of transaction. See John W. Loofbourrow Assocs., Inc., SEC No-Action Letter, [2006 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,239 (June 29, 2006); see also Brumberg, Mackey & Wall, P.L.C., SEC No-Action Letter, [2010 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,518 (May 17, 2010) (law firm proposed introducing potential buyers to a client interested in selling a particular type of security). Based on statements by the SEC staff, it seems unlikely that any finder’s arrangement that involved the finder receiving a commission based on a percentage of the selling price would qualify for the exemption. This would rule out any business plan modeled on Kickstarter – where the company’s website would serve as a medium for the introduction of buyers and sellers and, as Kickstarter and many donation based crowdfunding platforms do, the company would take as its fee a portion of the money raised – which is a model that

funding portals; Congress explicitly wrote an exemption into the JOBS Act that releases a funding portal from designation as a broker-dealer, although, as discussed in detail below, this exemption may present its own challenges.⁴¹

The purpose behind the special non-broker designation is likely the same as the purpose behind the 1933 Act exemption for registration of offerings: reducing the burden to a level sufficient to make participation in small, crowdfunding-sized offerings attractive. Registering as a broker-dealer under the Exchange Act is no easy feat. The would-be broker-dealer must first complete the SEC's own application form and must comply with any state-level requirements. The broker-dealer must also register with the Financial Industry Regulatory Authority (FINRA), the industry's self-regulatory organization. FINRA requires, among other things, that the broker-dealer and his or her employees pass various examinations to prove that they have sufficient knowledge to perform their duties. The SEC also imposes ongoing reporting requirements, and a requirement that the broker-dealer maintain certain capital levels to protect clients' accounts. Moreover, a registered broker-dealer is subject to a number of regulations governing how business may be transacted and making the broker-dealer liable for failure to comply with these regulations.⁴²

Although the JOBS Act includes an exemption for funding portals, it is not clear whether all portals will qualify for the exemption and, for those who do qualify, to what extent the exemption will prove to be a benefit. The JOBS Act specifies that the SEC has the authority to determine whether the exemption may be available "unconditionally" or "conditionally." It is not yet known how onerous those conditions, if any, may be. Additionally, under the Act, a portal is still required to register with the SEC; it is just not required necessarily to register as a broker-dealer.⁴³

many portals are likely to emulate. Kickstarter applies a 5 percent fee to the completed funds raised, RocketHub applies a 4 percent fee to the completed funds raised, and Indiegogo applies either a 4 percent or 9 percent fee to the funds raised, dependent upon type of funding. *FAQ*, KICKSTARTER, <http://www.kickstarter.com/help/faq/kickstarter%20basics> (last visited Oct. 27, 2012); *Crowdfunding, The Basics*, ROCKETHUB, <http://www.rockethub.com/learnmore/crowdfunding#what-does-it-cost-answer> (last visited Oct. 27, 2012); *How Pricing Works on Indiegogo*, INDIEGOGO, <http://www.indiegogo.com/learn/pricing> (last visited Oct. 27, 2012).

41. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 304(a), 126 Stat. 306, 321 (2012).

42. For example, these regulations include fiduciary duty, duty to disclose, duty of fair dealing, and others. *See* SEC. AND EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS 46-80 (2011), available at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

43. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, sec. 302(b), § 4A(a)(1), 126 Stat. 306, 316 (2012).

Under the JOBS Act, a portal must also register with any applicable self-regulatory agency, which currently means registering with FINRA.⁴⁴ FINRA has yet to issue rules governing funding portals and it is therefore unknown whether, for example, portal employees will be required to pass the same examinations that broker-dealers and their employees must pass.⁴⁵ Portals will also be required to make regular disclosures to the SEC but the nature of these disclosures is also unknown; the Act entrusts the SEC with the duty of determining which disclosures will be required and the SEC has not yet issued even proposed rules on this question. Final rules are due December 31, 2012.⁴⁶ Portals must also provide investor education, ensure that investors do not exceed the individual investment cap, prevent fraud, and protect confidential information.⁴⁷

In addition, a funding portal must ensure that the proceeds of the crowdfunding offering only reach the company when the target offering amount is reached, and allow investors to cancel their commitments to invest.⁴⁸ The SEC will produce rules outlining how this is to be accomplished,⁴⁹ and will likely provide clarity in its rules whether the company

44. The statute requires registration with a self-regulatory organization as defined by section 3(a)(80) of the Securities Exchange Act of 1934. See *Jumpstart Our Business Startups Act*, Pub. L. No. 112-106, sec. 302(b), § 4A(a)(2), 126 Stat. 306, 316 (2012). At the time of publication, no other such organization exists but FINRA.

45. FINRA has not stated when it expects to issue its rules although it has been accepting comments that will presumably inform the rule-making process. There is no deadline for the promulgation of these rules.

46. The Act does not, however, impose any sanction on the SEC if it misses this deadline. Additionally, while the Act states that the SEC must “issue” rules, it does not specify whether the rules must be adopted by this date, or by what date they must be effective.

47. While portals need not register as broker-dealers, there has been some interest among existing broker-dealers in serving as crowdfunding platforms to compete with the newly formed portals. That is, while all platforms are not broker-dealers, some broker-dealers will likely be platforms.

48. *Jumpstart Our Business Startups Act*, Pub. L. No. 112-106, sec. 302(b), § 4A(a)(7), 126 Stat. 306, 316 (2012).

49. Using an escrow agent is the most obvious method. Senator Scott Brown, however, has proposed allowing intermediaries to “place a hold on investor credit cards until an offer is fully subscribed. At that time, investors’ credit cards should be charged and the proceeds immediately transferred to the issuer.” 58 CONG. REC. 52, S2231 (daily ed. Mar. 29, 2012) (statement of Sen. Scott Brown). Given how widespread the use of credit cards is for online transactions, this may at first appear to be a simple solution. But the Federal Reserve’s Regulation T will likely eliminate the existence of that solution. See 12 C.F.R. §220 (2012). While Regulation T only deals with the extension of credit by brokers via margin accounts, it is common practice that brokers do not let customers open a margin account or charge a securities purchase to a credit card. See also *Investing with Borrowed Funds: No “Margin” for Error*, FINRA, <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/MarginAndBorrowing/P005973> (last updated June 21, 2012). Even for customers that have margin accounts, we will assume here that crowdfunding securities will be classified as non-marginable, and any purchase of such securities on credit would be highly suspect and/or not allowed entirely. See *Non-Marginable Securities*, INVESTOPEDIA, http://www.investopedia.com/terms/n/non_marginable_securities.asp#axzz266Mlgmey (last visited Sep. 10, 2012), for a definition of non-marginable securities.

needs to use a licensed escrow agent, or if funding portals will be able to perform that role.

Although these general requirements are written into the JOBS Act, what will be sufficient to satisfy the requirements is again left to the SEC to determine. Moreover, the Act permits the SEC to issue additional rules imposing other requirements “for the protection of investors and in the public interest.”⁵⁰

It is clear that Congress envisioned the portals as the primary bulwark against the fraud and other shady dealings that many feared would permeate the securities crowdfunding market.⁵¹ As part of this role, portals are likely to serve as the sole repository for all information on a particular offering.⁵² Given the responsibilities that have been placed on the portals, the lack of information about what the exact nature and scope of these responsibilities will be creates a challenging environment for portals just starting to build their businesses. Many in the crowdfunding world anticipate a tidal wave of pent up demand from issuers and investors to be unleashed when the SEC’s rules are finalized in January. Portals will want to be ready to absorb this wave of demand, but may be hampered if they do not know what will be expected of them.⁵³

V. WHAT HASN’T CHANGED

Has there been a sea-change in how small businesses access the capital markets? Yes. But let’s not get carried away. As important as it is to

50. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, sec. 302(b), § 4A(a)(12), 126 Stat. 306, 317 (2012).

51. It is likely that the SEC will take this tack as well. In a March 13, 2012 letter to Senators Tim Johnson and Richard Shelby, Chairman and Ranking Member, respectively, of the Senate Committee on Banking, Housing, and Urban Affairs, SEC Chairman Mary Schapiro urged the senators to strengthen investor safeguards in the Act by increasing SEC oversight of platforms, noting that “[w]ith Commission oversight, these intermediaries could serve a critical gatekeeper function, running background checks, facilitating small businesses’ provision of complete and adequate disclosures to investors, and providing the necessary support for these small businesses.” Letter from Mary Schapiro, Chairman, S.E.C., to Tim Johnson and Richard Shelby, U.S. Senators (Mar. 13, 2012), *available at* http://www.aicpa.org/advocacy/issues/downloadabledocuments/404b/3-13-12_sec_chm_schapiro_letter_to_johnson.pdf. It would not be surprising if the SEC used the authority granted by the Act to issue additional rules “for the protection of investors and in the public interest,” Section 4A(a)(12), to allow the SEC to enact an oversight regime consistent with the Chairman’s view.

52. A bedrock principle of federal securities laws is that all market participants have the same information. This is generally accomplished by requiring the issuer to file disclosures with the SEC, including the registration statement, that are then made available to the public (the so-called “monopoly of the prospectus”). Because offers made under the crowdfunding exemption are not registered, there will be a need for a different method of ensuring all potential investors have access to identical information. This may, incidentally, make it difficult if not impossible for an issuer to use multiple portals for the same offering.

53. Given this uncertainty, and the fact that portals will likely be subject to a fair amount of regulation, many platforms may decide to become broker-dealers if they are able to do so (e.g., have sufficient capital, etc.).

understand what has changed, it is equally important to understand what has not. Liability, both for the issuer and the platform, lurk in the recesses of existing laws. The new exemption has not de-fanged these provisions and, if anything, sections of the JOBS Act have only increased their reach. The would-be issuer or platform must understand where liability lies, or risks reputation-crushing litigation, sanctions, and fines. To get a handle on these risks, let's start with issuer liability.

Under Rule 10b-5, any person may be held liable for perpetuating a fraud in connection with the purchase or sale of a security, including making "any untrue statement of a material fact or . . . omit[ting] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . ."⁵⁴ Because sales of securities under the crowdfunding exemption are sales of securities just as much as the sale of any security issued by a Fortune 500 company in a traditional offering, this rule applies.⁵⁵ Additionally, Congress has elected to create a cause of action under the new Section 4A(c) of the Securities Act that is specific to offerings under the crowdfunding exemption, imposing liability on the issuer for a material misstatement or omission of a required statement.⁵⁶

Here's how these two types of liability are different (and why it matters). Rule 10b-5 applies to a larger group of people than the new Section 4A(c). Section 4A(c) applies only to the "issuer," (a very broadly defined term), while Rule 10b-5 applies to anyone making a misstatement "in connection with the purchase or sale of [a] security."⁵⁷ But Rule 10b-5 fol-

54. 17 C.F.R. § 240.10b-5 (2012).

55. In assessing the liability that an issuer may face, it is worth noting that, unlike an issuer of securities registered under the Securities Act or Exchange Act, issuing securities under the crowdfunding exemption does not make the issuer subject to the provisions of Sarbanes-Oxley, which, in addition to various forms of civil liability, subjects an issuer to potential criminal liability. *See*, Sarbanes-Oxley, § 302(a), 15 U.S.C. 7241(a) (requiring certification from, and imposing liability on officers of companies making periodic reports under § 13(a) or §15(d) of the Securities Exchange Act of 1934; because these reporting requirements are precisely those from which issuers are exempted under Title III of the JOBS Act, those issuers are not subject to liability under this section of Sarbanes-Oxley).

56. According to the Act:

An issuer shall be liable in an action under paragraph (1), if the issuer—(A) by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by any means of any written or oral communication, in the offering or sale of a security in a transaction exempted by the provisions of section 4(6), makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading, provided that the purchaser did not know of such untruth or omission; and (B) does not sustain the burden of proof that such issuer did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.

Jumpstart Our Business Startups Act, Pub. L. No. 112-106, sec. 302(b), § 4A(c)(2), 126 Stat. 306, 319 (2012).

57. The Supreme Court has recently clarified what it means to "make a statement." In *Janus Capital Group, Inc. v. First Derivative Traders*, the Court ruled that "the maker of a statement is the entity with authority over the content of the statement and whether and how

lows the common law in requiring that the plaintiff show that the defendant acted with scienter.⁵⁸ Section 4A(c) has no such requirement. In fact, it is the defendant's burden to show that he or she "did not know, and in the exercise of reasonable care could not have known, of such untruth or omission."⁵⁹

As for who may be liable, the Act's definition of an "issuer" sweeps in the company, any person who is a director or partner of the company, the principal executive, financial and accounting officers of the company,⁶⁰ and imposes upon these actors liability for "an untrue statement of a material fact" or omission to state a material fact in order to make a statement "not misleading." It is crucial to note that the definition also includes "any person who offers or sells the security in such offering." Applying the Supreme Court's analysis of "seller" for Section 12 purposes in *Pinter v. Dahl*,⁶¹ funding platforms would clearly fall within this category.

The next question is what constitutes a "material" fact. The definition has a simple formulation: "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."⁶² But applying that standard to a particular company's information can be challenging in any market. In a new market such as crowdfunding, the definition of who the "reasonable investor" is and what information he or she wants is still being formulated, creating a special challenge for the issuer and its counsel. Ultimately, the answer may be the same in the crowdfunding market as in any other securities market, but given the small size of the issuers, the (likely) relative youth of the companies, and the very small amounts that investors may choose to invest, it is possible that this market will require a more nuanced view of the materiality threshold.⁶³

to communicate it[.]" finding that contributing material to a prospectus attributed to another does not subject the contributor to 10b-5 liability in a private action, and significantly cabin- ing the reach of that type of liability. *Janus Capital Group, Inc. v. First Derivative Traders*, 131 U.S. 2296, 2303 (2011).

58. Scienter has been described by the Supreme Court as "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst and Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976).

59. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, sec. 302(b), § 4A(c)(2)(B), 126 Stat. 306, 319 (2012).

60. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, sec. 302(b), § 4A(c)(3), 126 Stat. 306, 319 (2012).

61. See *Pinter v. Dahl*, 486 U.S. 622, 640-47 (1988).

62. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

63. Despite the additional burden that Section 4A(c) imposes on issuers, it is notable that Congress elected to use the standard of Section 12(a)(2) of the Securities Act and not Section 11. Section 11 liability imposes strict liability for issuers. That is, if there is a material misstatement in the registration statement, the issuer is liable even if there was no way to know that the misstatement was material. The issuer's only defenses are that the misstate- ment was not material or that the purchaser knew of the misstatement before making the purchase. Moreover, Section 11 imposes liability on an extensive list of actors, including:

Issuers are not the only actors who may face liability. As stated above, the JOBS Act has cast the funding platforms in the role of gate-keeper and guard, and platforms will have to tread carefully to ensure compliance with new and existing regulations. Not only may they be subject to liability for misleading disclosure, as discussed above, but they also have exposure in other areas. For example, it is currently unclear whether a funding portal will be considered an investment adviser under the Investment Advisers Act of 1940. Section 202(a)(11) of the Investment Advisers Act defines an adviser as one who “for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities. . . .”⁶⁴ A person can also be considered an investment adviser if he or she “for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.”⁶⁵

There are already a number of funding portals in the start-up stage and each will likely look for services it can provide to distinguish itself as the most attractive option for both issuers and investors. Portals may therefore be tempted to offer a ranking system to guide investors to issuers that are (in the portal’s estimation) the safer investment. They may want to offer filters that allow investors to search for specific types of issuers, offer and moderate chat boards for the “crowd” to offer its wisdom on the best investments, or provide spotlights on the “issuer of the week” to promote certain issuers. Using such methods will no doubt be tempting to portals, especially given the widespread use of these tactics by many types of web services. But use of any one of these may very well subject the portal to designation as an investment adviser. Use of these tactics may also render a platform a ratings agency, a designation that carries its own registration requirements. Portals, unless they wish to take the steps necessary for

[E]very person who signed the registration statement; every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted; every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner; every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him; every underwriter with respect to such security.

Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (2006). These other actors, however, are not strictly liable but may defend themselves by showing that they conducted appropriate due diligence and were nonetheless unable to discover the misstatement.

64. Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2006). See BRADFORD, *supra* note 39, at 67-80, for additional discussion of whether crowdfunding sites are investment advisers and analysis of SEC No-Action letters on this topic.

65. Investment Advisers Act of 1940 § 202(a)(11), 15 U.S.C. § 80b-2(a)(11) (2006).

these registrations, should be wary of using any such device, tempting as it may be.

In addition, there is the wealth of both state and federal securities law and regulation that comes into play if an issuer or funding portal strays outside the confines of the crowdfunding exemption.⁶⁶ As we have noted, if an issuer has more than 500 non-accredited or more than 2,000 accredited holders of a class of securities, it will likely be required to register that class under the Securities Exchange Act. Additionally, if an offer intended to be made under the crowdfunding exemption fails to satisfy the requirements to be eligible for that exemption, it will likely be treated by the SEC as an offering made in violation of the registration requirements of the Securities Act. Finally, while there is not currently an explicit provision imposing liability on platforms for material misstatements by the issuers whose offers they host, the SEC and, eventually the courts, have sufficient latitude to impose some measure of liability in the future.⁶⁷

VI. CONCLUSION

While securities law is generally complex, and often requires counsel with expertise in the field, it is unlikely that most issuers relying on the crowdfunding exemption will require such expert guidance. (At least, one may hope so; we cannot be certain until the new rules are finalized.) Nonetheless, entrepreneurs who wish to become issuers under the exemption must rein in some of their characteristic “ready, fire, aim” exuberance and keep close tabs on compliance with the terms laid out in the JOBS Act. Most notably, issuers should be sure to:

- Understand all disclosures that are required and seek assistance in making these disclosures if there is any concern about what constitutes compliance;
- Have in place a method for keeping track of shareholders with the assumption that there will likely be at least hundreds and possibly thousands;
- Refrain from advertising an offering except as permitted by the Act, and understand that anything that may be considered market conditioning will likely be considered by the SEC and potential litigants to be an offer of securities even if the issuer did not intend it as such; and
- Evaluate whether it is necessary to register with the SEC if shareholders buying the issuer’s stock in the secondary market total 500 non-accredited or 2,000 accredited investors.

Platforms have been cast in a potentially more challenging role and it may be that they will ultimately serve to assist the issuers in staying on the right

66. Offers under the crowdfunding exemption are expressly exempt from most provisions of state securities laws. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 305(d), 126 Stat. 306, 323 (2012).

67. There is also a possibility that portals, acting as securities intermediaries, may be considered underwriters. See Thomas Lee Hazen, *Crowdfunding of Fraudfunding? Social Networks and the Securities Laws – Why the Specially Tailored Exemption Must be Conditioned on Meaningful Disclosure*, 90 N.C. L. Rev. 1735, 1760 (2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1954040.

side of the law. This will require careful deliberation by the platforms and will likely require the assistance of competent securities counsel. At a minimum, platforms should keep in mind that they must:

- Register with the SEC and FINRA, and ensure compliance with any rules promulgated by either of those bodies;
- Establish a means of ensuring that issuers do not receive the proceeds of a raise until the full funding threshold has been met; and
- Ensure individuals investing in securities listed on their sites have passed a financial literacy test that complies with SEC requirements.

To the extent that the platform intends to rely the new exemption for funding portals to avoid registration as a broker-dealer, the platform must refrain from actions that may unintentionally subject it to registration. Additionally, all parties involved in crowdfunding must be aware of potential liability for material misstatements.

With the new rules set to become final in the first part of the next year, we will likely see an active securities crowdfunding market in 2013. This first year will resolve many questions the answers to which are currently only guesses. For example, will the rules promulgated by the SEC be too onerous to be cost effective for a raise of \$1 million? What about for a raise of only \$100,000? Will the current anti-fraud provisions (i.e., the various registration and disclosure requirements) be sufficient to keep fraud at a tolerable level?⁶⁸ What private sector solutions may develop to deter fraud, assist the portals in meeting their obligations, and provide education for the public? And most importantly, how effective will this market be in promoting entrepreneurship and making a contribution to the ongoing effort to revitalize our country's economy? In a year's time, we will have a much clearer view of this new market, including its high points, and its low.

68. Fraud, of course, can only be prevented entirely by not having the market in the first place. We can expect fraud in the securities crowdfunding market because fraud will exist wherever there is an opportunity for someone to make money. An effective regulatory regime keeps the fraud at a level that is acceptable to society. What that level is may also be a question to be resolved in the coming year.

